MEMORANDUM

Date: February 14, 2011

To: Investment Committee

From: Pension Consulting Alliance, Inc. (PCA)

RE: CalPERS Real Estate Strategic Plan

In our capacity as the Real Estate Consultant to the Board, PCA has reviewed the proposed Strategic Plan for the CalPERS real estate program. This plan was written in keeping with the recent asset allocation study which defined a revised role for the real estate asset class as a component of the overall CalPERS investment portfolio. The new role of real estate can essentially be summarized as:

- providing low correlation to equities;
- generating a less volatile return pattern derived from completed, income-oriented, moderately levered investment-grade commercial properties designed to provide stable cash yields; and
- a partial inflation hedge.

Given this new objective for the real estate portfolio, the strategy will primarily focus on investment through private investment vehicles due to the lower correlation with equities.[1] Furthermore, property fundamentals will be emphasized, as investments will be primarily in core (i.e., stabilized and leased) properties located domestically that generate the majority of their total return through income.

PCA believes a focus on domestic core properties achieves the new role of the real estate asset class and reduces risk, as measured by volatility, in the overall portfolio. Additionally, the proposed strategic plan also incorporates lessons learned from the previous downturn where the System suffered substantial losses in the value of its real estate portfolio. As previously described by Staff and PCA, the losses suffered in real estate were primarily driven by: (a) vintage-year concentration and (b) investment focus on non-core assets with high amounts of leverage. While PCA believes that the real estate asset class is likely to remain cyclical and CalPERS will, therefore, experience other periods of poor relative performance, PCA believes that with proper oversight and active risk management, a moderately levered core-oriented portfolio will better insulate CalPERS from such severe losses in the future and meet the new asset class mandate adopted by the Board.

To meet the mandate for real estate, PCA believes a higher minimum percentage for the core risk category is more likely, over the long term, to achieve the Investment Committee's adopted goals. PCA believes in order to make the plan consistent with the role of real estate, and increase the ability to avoid losses, core should be no less than 75% of the portfolio, and the maximum amount of non-core should be 25% of the portfolio.

[1] As reported in NCREIF, and in part due to quarterly, versus daily, mark to market.

Based on the current complexion of the real estate portfolio, the overwhelming majority of new investment dollars will, therefore, need to be focused on core properties. **As such, the real estate portfolio will be in a period of transition for the next three to five years as Staff works to implement the new strategic plan and move the portfolio into alignment with the newly adopted role of real estate.**

In addition to a domestic core program, the new strategic plan includes both a domestic tactical program and an allocation to emerging markets in order to capture the demographic shifts in countries such as Brazil, India and China. PCA believes these non-core components will likely be beneficial to the overall plan.

Emphasis should be placed on moving forward with the core program and an orderly and optimized disposition of the non-conforming legacy assets over a three- to five-year period. The strategy for doing so will need to be developed and reported to the Investment Committee. In PCA's opinion and experience, for example, the orderly sale of the REIT portfolio can be accomplished within a shorter time period than the Staff projected.

Additionally, due to CalPERS' size and resource constraints, CalPERS will invest mainly through separate accounts overseen by the Real Estate Unit. This approach is designed to increase the likelihood that CalPERS will have the appropriate rights and governance provisions. This structure also provides for more influence on the overarching strategy of individual investment mandates that are managed by third party fiduciary advisors.

PCA also notes the proposal of Staff to invest through operating companies in addition to separate accounts. This is an interesting idea and well worth additional study. If positive, then the implementation plan can be brought back to the Investment Committee at a later date.

With the implementation of the new strategic plan, the organization of the Real Estate Unit (REU) has changed. New roles and responsibilities for Staff will be undertaken and PCA will continue to work with the SIO to ensure that the portfolio is managed in accordance with the plan over the course of the next few years.

As with any organizational change, it will be necessary to carefully monitor its implementation and execution. This change will be no small undertaking. To successfully shift the real estate portfolio to achieve the new role of real estate as directed by the Investment Committee will require close cooperation and coordination within and without the REU. PCA will monitor the organizational shift and keep the IC apprised.

Additionally, critical to the success of the new strategic plan will be a need to structure appropriate incentive compensation alignment for the Staff and for the investment managers. This component will be an important factor to be addressed in implementing the new plan. As part of the process to implement the new strategic plan, PCA will work with Staff to recommend any necessary changes to the investment policy and the procedures manual for real estate, as well as systems and monitoring.

Therefore, key milestones will be reported to the Board during the next months as Staff and PCA work towards modifying operating agreements with investment managers and implementing the initial stages of the strategic plan. This process is already well underway.

PCA believes that, then the REU can reliably meet the requested real estate risk and return targets over time with a moderate amount of positive leverage on a predominately core portfolio, and effectively manage the distractions, complications and risks (development, construction, leasing, control, governance, currency, tax, portfolio management resources and skills) which accompany more aggressive and/or offshore investing.

Based on our review of the proposed strategic plan, and subject to the comments listed above, PCA concurs with the Staff that this new real estate strategic plan will support the needs of the System as prescribed in the asset allocation study adopted by the Investment Committee.